CHAPTER 6

Status of Islamic Finance in Germany in 2019

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6.1 Introduction

As the leading economy in Europe, Germany is a crucial market for Islamic finance. Not only the approximately 5 million Muslims in Germany but also all the people disappointed with the conventional financial market in the aftermath of the recent financial crisis are a huge market potential for Islamic finance. Germany's state officials and other market actors have made several efforts in order to establish Islamic finance in Germany. There are numerous positive statements, among others from the former Minister of Finance Wolfgang Schäuble, who said in the G-20 that Islamic finance is gaining importance.[1] Also the two conferences organized by the German banking regulator *BaFin* itself in past with the participation of leading international scholars and researchers—one on Islamic banking in 2009 and another on Islamic capital markets in 2012—and the planned conference in 2019 on *Takāful* are such important attempts. In general, the German public and media are open minded, interested and quite

[1] http://www.faz.net/aktuell/wirtschaft/wirtschaftspolitik/g20-treffen-in-ankara-schaeuble-islamische-finanzierungsmodelle-wichtiger-13787046.html (23.05.2018).

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benevolent to Islamic finance.[2] Despite all that, it took a pretty long time until 2015 when the first Islamic bank was granted a fully fledged banking license (more than ten years later in comparison with London). In my chapter I want to show the historical development in the German market (Sect. 6.2), the present situation with the relevant actors and main products, remaining challenges (Sects. 6.3, 6.4, 6.5 and 6.6) and finally an outlook for a likely development in the near future (Sect. 6.7).

6.2 Historical Outline of the German Market

It is quite surprising to learn that it was Germany where the foundation for the first attempts of the modern Islamic banking industry in the twentieth century was laid. Ahmad el-Nagger, the great pioneer of Islamic banking, who has finished his doctoral thesis in Cologne, has used the public saving banks (*Sparkassen*) in Germany as the blueprint for *Mit Ghamr*, a savings bank in Egypt (founded in 1963), which itself is considered as one of the first Islamic banks.[3]

But also in practice Germany is one of the leading, innovative markets in Europe. Based on real estate leasing as the underlying asset, it was the federal state of Sachsen-Anhalt which has issued successfully the first *Ṣukūk* in Europe in 2004. It has attracted strong demand with investors from the UAE (60 percent) and Europe (40 percent).[4]

Besides these positive cases, there were also some unpleasant events in the financial gray markets with superficial connections to Islamic Finance. In the 1990s a new kind of partnership was very popular in Turkey which quickly found its way to Germany: a profit and loss sharing silent partnership. The investor pays the money in exchange for an unofficial paper, granting him a share of a company claiming to be Islamic. In practice there were no losses and the profits were exorbitantly high. Actually, it was simply a pyramid scheme where the company distributed high amounts from the collected money—declared as profit—in order to attract just more money. It is assumed that an amount between EUR 5 billion and EUR 50

[2] There were about 2000 articles on granting the first fully fledge banking license to an Islamic bank and nearly all were with a positive echo.

[3] Umar Oseni and M. Kabir Hassan (2010), "The Emergence and Development of Islamic Banking" in: Islamic Finance – Instruments and Markets, p. 113.

Ahmad el-Naggar, Zinslose Sparkassen im Nildelta, Al-Kitab-Verlag.

[4] European Central Bank – Eurosystem, Occasional Paper Series, Islamic Finance in Europe, No. 146, June 2013, p. 26.

billion was embezzled.[5] Some comments suggest that this fraud is at least an indicator for an existing demand for Islamic compliant products.[6] But a more plausible explanation is that also Muslims are not immune against greed as a lot of investors even took conventional interest-bearing loans from banks in order to buy those so-called Islamic company shares. Obviously the promised (and initially disbursed) profits of 10–20 percent of the paid equity were double or triple as high as the market standards and were as such suspicious. But what is definitely true is the absence of legitimate financial investment alternatives for Muslims under state regulation and control in that time, which made it easier for dubious contractors to cheat the poorly experienced investors. Nowadays the burden of that legacy is still high as a lot of potential middle-aged investors are still very distrustful to any Islamic branded financial products.

This distrust might be the main explanation for the failure of a whole series of several types of investment funds. Commerzbank, through its daughter Cominvest, was one of the earliest actors which offered an Islamic compliant investment in 2000 (*Al-Sukoor* Fonds).[7] But after the volume of the fund decreased from the initially EUR 30 mio to less than EUR 4 mio (end of 2004), Cominvest took away the *Al-Sukoor* fund from the market (in 2005).[8]

A similar fate faced several other Islamic compliant investment funds in Germany: Meridio (mixed fund, closed 2011), Allianz Global Investors (equity fund, closed 2012), *Landesbank* Berlin (global investment certificate, closed 2013), West LB (certificate on the ten largest German Islamic compliant companies, closed 2013) and Deutsche Bank's DWS (mutual fund, closed 2016). There are still some funds from non-German banks available, but their success is modest and they are generally unknown.[9]

[5] A. Farhoush, M. Mahlknecht (2010), A critical view on Islamic Finance in Germany, p. 204 in: pp. 203–212.

[6] Chahboune, Jallale/El-Mogaddedi, Zaid (2008), Islamic Banking – das Marktpotenzial in Deutschland, in: Zeitschrift für das gesamte Kreditwesen, 15, 01.08.2008, p. 34.

[7] Commerzbank, Geschäftsbericht 2000, p. 19.

[8] Alharbi, Ahmad (2016), "Development of Islamic Finance in Europe and North America: Opportunities and Challenges", p. 116 in: International Journal of Islamic Economics and Finance Studies, Nov 2016, Vol. 2, Issue 3, p. 109–136.

[9] A. Farhoush, M. Mahlknecht (2010), p. 206.

Besides this there are some smaller sale companies, which operate in a niche and promote Islamic compliant products,[10] mainly gold-saving products, *Takāful* and some other investment products.

6.3 Present Situation

Despite the flop in the investment segment, there is one quite successful investment company, Arabesque Asset Management, based in Frankfurt am Main and London, which has still Islamic compliant funds. But with regard to the failure of the other market actors, it is not really surprising that it does not promote this feature. Being rather a sustainable and socially responsible fund which is coincidentally Islamic compliant, Arabesque offers its products mainly to clients interested in socially responsible investments and is hardly known in the German Muslim community.[11]

Another important player is FWU, an insurance company in Munich, which offers *Takāful* products in Europe and Asia. FWU promotes its products to Muslims and non-Muslims. Even in a Muslim country like Malaysia there are more non-Muslim clients than Muslim one.[12] For the Muslim clients in Germany they have used the existing sales company (see above), but recently stopped cooperation and active marketing.[13]

Quite recently a very interesting approach appeared in the German market: the Turkey-based *Al Baraka* Turkish Bank's subsidiary *insha GmbH* entered the German market as a fintech company. As a fintech company *insha* doesn't need a banking license. It cooperates with the *solarisbank* AG, which in turn is also a start-up, founded some years ago.[14] It is a fully fledged bank which has no end-user business and offers its service only to non-banks in order to enable them to realize the business models requiring a banking license.

Al Baraka Turkish Bank is one of the pioneers both in Islamic banking and in the new fintech industry in Turkey. Starting with payment products, *insha* wants to offer all classical banking products via a smart phone

[10] Presently (2018), there are the following companies: *inaia GmbH* (formerly *ifis Capital Gmbh*), My Islamic Finance and *ZinsFrei* (formerly *fmf*).

[11] For more information, see: https://arabesque.com/

[12] According to public statements of M. Dirrheimer, owner and CEO of FWU.

[13] Due to a call with Mr. Ansari from FWU on 17.7.2018.

[14] For more information, see: https://www.solarisbank.com/en/

application in the long run for retail as well as for corporate clients.[15] The start of the business was August 2018.

6.3.1 First Islamic Bank: KT Bank

The most important progress in the Islamic finance market in Germany was the granting of a fully fledged banking license for the 100 percent subsidiary of the Kuwait Turkish Participation Bank, the KT Bank, in March 2015. Besides Bosnia-Herzegovina and the Islamic banking hub of London, the KT Bank's activity is the first one within the Eurozone. Kuwait Turkish Bank spent a long time in intensive preparation and performed crucial pioneering work. They first began in 2004 with a representative office for market observation. Then they applied and granted licenses for third-country brokerage and money transfer in 2009. Based on these experiences they finally applied in October 2012 for the banking license.

Within that time period they not only gathered market information, but also informed the public, the banking authority, the media and the politicians about their company and their objective, the essence of Islamic banking and the benefits of this approach for the German market.

With two and a half years, the licensing process took a quite long time, double as in other cases. But it was not due to any resentments but due to the fact that it was a precedent-setting case within the Euro area. Although there is no "Islamic banking license" but just a banking license, there were some Islamic banking-related issues, mainly the question of whether there is a sufficient large market potential for Islamic banking,[16] independence of the management from the *Sharīʿa* board[17] and the compatibility of the profit and loss sharing accounts (pls accounts) with the deposit definition according to the German banking law (*Kreditwesengesetz*, KWG). The latter one requires no interest payment for deposits but the categorical repayment of the clients' money,[18] which seems to be apparently a contradiction to the pls account. But a sophisticated analysis on part of *Bafin* and the responsible institution for the

[15] For more information, see: https://www.getinsha.com/en

[16] The absence of a stable, sustainable business model is reason to refuse the license.

[17] Even though there were explicit written rules of order of the bank, declaring the independence of the management, the banking supervisory authority *Bafin* doubted that fact as in their view the factual influence due to the knowledge of the scholars would be harmful.

[18] According to §1 (1) of German banking law (*Kreditwesengesetz*, KWG).

deposit protection scheme (*Prüfungsverband Deutscher Banken*) came to the conclusion that in the end the preventive measures of an Islamic bank lead to the same result. Recognized preventive measures as such were the profit and loss stabilization reserves, shareholders' profit relinquishment and equity buffer.

6.3.2 Product Range of KT Bank

KT Bank is a universal bank offering all classical banking products for retail and corporate clients. Customers can deposit their money in current accounts or save money via pls accounts, make payments and take loans for moveable goods or real estate. It offers banking and credit cards where the client could make payments and draw out money globally.[19]

Besides the products for the end users, KT Bank also has instruments for the inter-banking market, where it makes business with conventional banks due to liquidity reasons. Within this context it deploys the instrument of *tawarruk* based on precious metal exchange.

6.4 Legal Issues and Solutions for Islamic Compliant Products

Germany has no special regulation or legal adaption for Islamic finance. Thus, one of the most important achievements of the KT Bank was to having found tax and legal solutions and paved the way for Islamic compliant products. Besides the integration of the pls accounts in the deposit guarantee scheme, one of the most important hurdles for Islamic compliant financial products within a non-Islamic regulatory framework is the additional cost burden in *murābaḥa* transactions, namely, the double stamp duty in real estate finance and the extra VAT for the profit margin. As interest income for conventional banks is free of VAT, this extra burden of 19 percent would constitute an important competitive disadvantage for Islamic banks. But in a precedent case the local tax authority in Frankfurt am Main has ascertained in 2014 that the *murābaḥa*-based profit margin has to be treated like an interest income and thus be free of VAT.

Another challenging issue for the establishment of Islamic banking was to find tax solutions for the real estate finance which ensures tax costs in line with the market prices for the clients. Thus, a simple *murābaḥa*

[19] For more information, see https://www.kt-bank.de/

transaction with the consequence of a double stamp duty, which is up to 6.5 percent of the purchasing price in some states,[20] did not come into consideration. The KT Bank developed a special form of a diminishing *mushāraka*, whereby the shares of ownership change not at the time of payment (in general monthly) but in advance on a *murābaḥa* basis with deferred payment. First of all, the bank and two customers establish a firm under civil law (*Gesellschaft bürgerlichen Rechts*, GbR), which itself buys the real estate. The bank then sells its share at once (a one-period sale) or in several time intervals (a several-period sale). As the sale of the shares does not constitute a new ownership—the GbR still owns the object—there is no second stamp duty.

But this product is not only highly innovative in terms of tax avoidance, but also as a long-term real estate finance tool: on the one hand, the several-period sale guarantees the client a fixed profit rate for the current time period, and on the other hand, it offers the bank enough price flexibility to structure the duration of this financing instrument according to market standards, that is, for 20–30 years. At the end of each tranche of finance, the bank makes a new price offer for the next one. The customer could accept it or opt out by paying the remaining shares, which are fixed at the very beginning of the transaction. He could pay out by own means or by a third financier.

6.5 Performance and Evaluation

The investing mother bank Kuwait Turkish Bank has made great efforts to make the engagement in Germany a success. It took a long time for market research, to inform all stakeholders, for intensive preparation and has invested huge sums. The performance of KT Bank is not only of relevance for the mother company but for the whole market as other potential investors know the enormous efforts and observe KT Bank's performance as an indicator for the market potential and decide their market entrance depending on that evaluation.

Without a doubt, KT Bank has performed exceptional pioneering work for the Islamic banking industry in Germany and was very successful forming the public opinion positively for the Islamic banking industry and

[20] The real estate transfer tax (*Grunderwerbsteuer*) is a state-based tax and differs accordingly. It ranges between 3.5 and 6.5 percent of the purchasing price.

engineering innovative products which enabled Islamic compliance under level playing fields. However, at the end of the day the financial numbers matter.

KT Bank's strategy was to act as the first mover within the Islamic banking niche. Soon after the start, the bank focused mainly on Muslim clients.

Based on the annual financial statements from 2015 to 2017,[21] the following results become apparent. Also in the third year of business, there was a loss of EUR. 7.6 mio (after 11.4 and 9.3 mio in 2016 and 2015, respectively), cumulative: EUR 28.4 mio. At the end of 2017, the KT Bank had 5435 retail and 1229 corporate customers in comparison to the declared goal of 20,000, according to public statements.[22] The balance sheet increased to EUR 193 mio (after 108 and 54 mio). The loans granted to non-banks—the basis of the bank's earnings—were only 125 mio (after 60 mio) and the client deposits 89 mio (after 38 mio). Approximately two-thirds of the deposits are current accounts, and only 33 mio are pls accounts, of which 17 mio have a maturity under one year. The latter amount shows the main problem for KT Bank: finding maturity-adequate sources for refinancing. This is the reason for the small share of loans to non-banks (more than a quarter of the balance sheet, 48 mio, is either held at the central bank (18.6 mio) or at other banks (28 mio), both with marginal or even negative returns).[23] KT Bank did not succeed in really tapping the potential and reaching retail customers. The officially declared number of 20,000 clients was not a very ambitious goal, but the number of 6000 customers in three years is disappointing.

Probably due to this, KT Bank has made a shift of paradigm and offers saving accounts with fixed returns since 2018. The reason behind this is that the bank is obviously trying to reach non-Muslim customers in order to broaden its refinance basis. But on the other hand the existence of a fixed-return product questions the credibility of the underlying business model for Muslim customers.

[21] As there is no information in the home page of KT Bank, the annual financial statements are publicly available in (after filling in "KT Bank" in the search field): https://www.bundesanzeiger.de/ebanzwww/wexsservlet?global_data.language=en&session.sessionid=094082d1418518649a46fcd70e3e9215&page.navid=gotolastpage

[22] See annual financial statements of KT Bank, 2016.

[23] Besides this 1.6 mio is held in cash.

6.6 Remaining Challenges: Regulatory and Governance Issues

As mentioned above there is no Islamic banking-specific regulation in Germany. Therefore, some problems and challenges in Islamic compliant governance are inevitable. Basically, there is a conflict of interest between shareholders, bank management and customers. Between the first two there are well-known issues in principle-agent topics. And often both their interests are in contrast to the customer's. As there are two main sources for the management—shareholders' equity and depositors' money—there is always a conflict of interest on which source exceptionally profitable projects should be invested. The same is true for the degree of capacity utilization. If the management tends to utilize the equity to a higher degree and keep the customers' deposits unused for liquidity reasons, the return for the customers will be less.

6.7 Conclusion and Outlook

Germany has a long tradition in Islamic finance, often as a pioneer. The legal, regulatory framework is still challenging, but—thanks to Kuwait Turk's efforts—not an unbreachable obstacle. What is needed is a neutral institution, which could function as a third-party certification and a mediation body ensuring transparency and good governance.

A lesson from the failures and successful approaches in Germany is that an inclusive, all-customer comprising approach is needed. Certainly, there is great interest and demand for Islamic compliant financial services in Germany. But to be Islamic is a necessary but not a sufficient condition in order to be successful. Quality of service, smart, state-of-the-art and user-friendly technology and competitive prices are of course also of relevance. Islamic compliance is an advantage as a door opener but you have to offer an additional benefit to your customer, regardless of which religion he or she belongs to. It is not by chance that only one Islamic compliant investment fund, Arabesque, which does position itself as a sustainable, socially responsible investment, operates successfully. From that perspective *Al Baraka* Turk's fintech, *insha*, is also a very interesting approach.

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